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Restructuring of Enterprise Social Assets in Russia

Trends, Problems, Possible Solutions

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What to do about social services that Russia's state enterprises have traditionally provided is a major issue in enterprise restructuring and public policy reform. If taxes and the provision of social services are rationalized at the time those social assets are divested, pioneering steps could be taken in restructuring the social sector.

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Summary findings

Public enterprises in the formerly socialist countries have provided many social services to employees and the public, services that divert them from their core activities, raise their costs, and keep them from being competitive. How to deal with these social assets is a major problem in enterprise restructuring: Large insolvent enterprises that provide many social services in a community often have the bargaining power to delay bankruptcy procedures and force the state to continue subsidizing them. But users of social services are not protected from enterprise managers' arbitrary actions or from a general deterioration in the level of services provided.

As enterprises are restructured, the public sector must become involved in (1) protecting critical services, such as kindergarten, that might otherwise disappear as enterprise funding is reduced, (2) facilitating reform of housing and health services, among others, (3) guaranteeing citizens' access to public services, and (4) reducing costs by rationalizing the management and provision of services. Freinkman and Starodubovskaya analyze policy options in the restructuring of enterprises' social assets.

They argue that the options differ depending on the benefits. Some benefits should remain as part of a traditional labor compensation package, and others should be privatized or transferred to municipal governments. Housing, especially, and child care facilities are services enterprises should not be in the business of providing, they contend. Divesting enterprises of housing is a transitional strategy on the way to transferring its ownership and management to the private sector.

Unfortunately, the rules of the game under which municipal governments divest enterprises of housing are nontransparent and entirely under municipal control, and vested interests have many ways to postpone or block divestiture — even though most enterprise managers welcome it because it will reduce their costs and administrative burden.

Social spending by Russian enterprises represents as much as 20 percent of gross wage costs. Shifting and reducing those costs requires smart financial and tax planning, sound regulations, and housing reform (including greater cost recovery), among other things.

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Restructuring of Enterprise Social Assets in Russia: Trends, Problems, Possible Solutions

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INTRODUCTION

The problem of enterprise social assets is one of the most important issues facing enterprise restructuring. The extensive provisioning of social services to both employees and general public in surrounding communities diverts enterprises from their core activities. Financial and administrative burdens associated with social services raise costs and prevent enterprises from being competitive. Social assets are considered as an additional barrier for external investors who might refrain from investments in enterprises with large social liabilities. Additionally, in cases where large potentially insolvent enterprises provide a number of social services to their communities, it increases the bargaining power of such uncompetitive enterprises vis-a-vis governmental authorities. It makes very it difficult for bankruptcy procedures to be initiated against them, and forces the state to continue to subsidize them. Users of enterprise social services are often not protected enough from arbitrary actions of enterprise managers and a general deterioration in the level of provided services.

The downsizing of enterprises' social activities means that some other agents will have to perform these functions in their place. That is why the issue of enterprise social assets is not only one of the crucial components of industrial restructuring, but is also closely connected with both public and social sector reforms. There are a number of purposes for the public sector's involvement in substituting enterprise social functions: (i) protection of some critical elements of public services (e.g. kindergartens), which might otherwise disappear due to reductions in enterprises' funding; (ii) facilitating of reforms in both housing and delivering mechanisms for some public services (e.g. health services), which would be easier if all corresponding assets were temporarily concentrated under the management of municipal governments; (iii) guaranteeing adequate access for citizens to important public services, largely because social activities of enterprises are sometimes delivered at a much higher, sometimes at a much lower, level than public ones; (iv) financial savings through rationalization of management and provision of services. At the same time, some former enterprise social assets could be either privatized or used to introduce new institutional reforms in the public sector. These assets are not necessarily to be transferred to existing public governance structures and fall under the control of prevailing interests therein. So, the divestiture of these assets could make them pioneers in social sector restructuring and, therefore, might facilitate social sector reforms in general.

¹ The paper reflects some findings derived from the preparation work done under the World Bank's Enterprise Housing Divestiture Project. The Project was managed by Dennis Whittle and Mari Kuraishi, whom we are very grateful for stimulating discussions and organizational support. We thank also Marina Krasilnikova, Olga Shabalina, Jeff Procak, Alexander Morozov, and Natasha Veligura for helpful comments and help with collecting and processing the data. Any errors are our own.

At the same time, it's quite clear that the ultimate objective in cases where enterprises provide households with heavily subsidized private goods is comprehensive privatization of corresponding services and subsidy elimination. However, due to existing political and social constraints, immediate implementation of such policies is considered as unacceptable by most governments in transitional economies. The whole problem of divestiture is derived from the necessity to design a procedure that would substitute enterprises by municipalities in a way which preserves continuation of basic services and takes into account major fiscal and institutional consequences of such a substitution. Therefore an appropriate divestiture policy must be seen as a transitional strategy that is accompanied by measures to push the ownership, financing, and management into the private sector.

While the importance of this problem for the Russian economy has been widely recognized (World Bank, 1994), very little empirical analysis has been done, and only recently has the situation begun to change. Among the recently prepared most detailed studies are the paper written by Simon Commander and Une Lee (Commander and Lee, 1995) devoted to the scope of social benefits which are typically provided by Russian firms, as well as the Report on Russian Enterprise Housing Divestiture prepared by the group of experts from the Urban Institute (Urban Institute, 1995). Both of these papers are based on enterprise surveys and interviews. A number studies of the problem with enterprise social assets transferral have been started recently with respect to other FSU countries (ADB, 1995; Cheasty, 1996; O'Keefe, 1995).

This paper is based on some additional sources of information, which include various macro and sectoral data provided by the Goskomstat and the Ministry of Economy of Russian Federation. It also includes data collected in the course of preparation of the World Bank Enterprise Housing Divestiture Project.² This survey of 24 enterprises was conducted in 10 cities at the end of 1994 and beginning of 1995. Respective municipalities were also surveyed. Though the study was primarily directed at enterprise housing issues, the problems of other social assets and benefits were also taken into account. Additional information on legal and financial framework of enterprise social assets functioning and divestiture was collected from eleven cities who competed for participation in the project through a number of interviews with city officials and enterprise managers.

This paper has the following structure. The first section describes the major trends in overall enterprise social spending over 1992-94. Section two discusses major factors influencing restructuring of enterprise social assets, among which macroeconomic, legal, and financial parameters. The third section provides brief summary of major potential directions of such restructuring, including newly-reconstituted forms of enterprise control over social assets, divestiture and privatization. Sections four and five discuss potential consequences, including financial impact, of social asset divestiture on correspondingly enterprises and municipalities. Section six is focused on barriers for divestiture, while the remaining section provides some recommendations to facilitate the divestiture process. A more detailed description of the enterprise sample is presented in the Annex 1. The second annex lists major government regulatory acts, which govern the divestiture process in Russia. Annex 3 describes the peculiarities of providing social services by enterprises in two specific sectors, agriculture and coal. Annex 4 presents a case study of Vladimir Tractor Plant, which demonstrates the scale of potential benefits from divestiture for a typical Russian manufacturer.

² This information was partially used in the paper of S. Commander and U. Lee mentioned above.

1. THE SCOPE OF THE PROBLEM

This section provides some macro estimates concerning the overall scale of Russian enterprise involvement in delivering social services. It could be argued that while being quite substantial, enterprise social spending is still much lower than some earlier estimates that were derived from small enterprise surveys. In particular, such spending did not surpass a level of 15% of GDP (Alm and Sjoquist, 1993) not did it amount to 40% of the wage bill (Commander and Jackman, 1993).

Table 1 provides some estimates of the value of social assets at the disposal of Russian enterprises before the intensification of the divestiture process in 1994. By the end of 1993, total social assets amounted to 5% percent of the total fixed capital assets accumulated by the enterprise sector. Assets in housing and utilities made two thirds of this total, and assets in education and health exceeded 20% of total social assets. (This data is derived from Goskomstat's regular annual statistics (form No. 11).) Due to high inflation in Russia and the unsatisfactory way in which the accumulated stock of fixed capital has been revalued, the quality of the provided data is not very high. In particular, it is not comparable across stock (accumulated social assets) and flow (new construction of social assets in 1992-93) variables. Despite these deficiencies, this information is useful in considering the structure of the social assets' accumulated stock. Table 1 also suggests that divestiture was very slow in both 1992 and 1993.

As reported by Goskomstat,³ total social spending by the enterprise sector amounted to about 3.1% of GDP in 1993 and 3.5% in 1994. Social spending in 1993-94 decreased by 30% (in real terms) compared to its 1992 level. Enterprises did not make any additional reductions in real social spending in 1994, despite the partial divestiture of social assets occurring during this year and the general deterioration of the overall financial position of the enterprise sector. This can be explained by continuation of cash wage restrictions in the form of the excess wage tax, which, together with relatively high rates of payroll taxes in Russia, encouraged enterprises to make shifts within their benefit packages towards more non-cash benefits, including social services. As a result, 1994 social spending constituted a much larger share of gross profit in the economy than in 1993. About 30% of the overall 1994 social expenditures was spent on housing maintenance, 22% on education and health services, and about a quarter on new investments in social assets (Table 2). More than 60% of the total amount in 1993-94 was spent by industrial enterprises employing less than 30% of the total Russian labor force (Table 3).

Enterprise social spending as a whole was the equivalent to a little more than 25% of total consolidated budget spending on social purposes and housing in 1993⁴. This share dropped to 22% in 1994 due to a relative decline in enterprise spending on both housing and health. Enterprise contributions to financing housing maintenance were equivalent to almost 30% of the actual budgetary spending on this purpose in 1993. They declined to 23% in 1994.

³ The numbers are derived from Goskomstat's official publication (form No. 10f) of financial indicators for various sectors in the Russian economy. The quality of these data is discussed below.

⁴ This does exclude transfers from extra-budgetary funds, i.e. government expenditures on social protection.

Table 1. Social spending by the enterprise sector in Russia, in 1992-94 in real and nominal terms.

	1992	1993	1994
Social spending, total, trln rb, current prices	0.739	5.36	21.12
- health	n.a.	0.99	2.79
- education and culture	n.a.	0.58	1.78
- housing, only maintenance	n.a.	1.96	6.48
- investments	n.a.	n.a.	5.42
- other	n.a.	1.83	4.65
Social spending, total, as % of GDP	3.89	3.13	3.46
Social spending, total, real, 1992=100	100	72.89	71.27
MEMO:			
GDP, trln. rubl	19	171.5	611
CPI	14.54	9.95	4.03

Source: Goskomstat, own estimates

Table 2. Social spending by the enterprise sector in Russia, in 1993-94, trln. rbl.

	1993			1994		
	Total	Industry	Agriculture	Total	Industry	Agriculture
1. Social spending, total	5.36	3.47	0.43	21.12	12.99	1.564
- health	0.99	0.64	0.086	2.79	1.93	0.126
- education and culture	0.58	0.41	0.047	1.78	1.29	0.159
- housing, only maintenance	1.96	1.15	0.169	6.48	3.97	0.486
- investments	n.a.	n.a.	n.a.	5.42	2.83	0.506
- other	1.83	1.27	0.128	4.65	2.97	0.287
MEMO:						
2. Revenue from sales	184.2	107.6	9.52	607.77	357.68	25.61
3. Total costs, 3/	152.6	85.9	7.65	545.28	304.8	28.02
4. Profit from sales	31.2	21.8	2.06	62.49	47.37	-2.5
5. Total gross profit, net losses	37.5	26.73	2.8	80.44	52.71	-0.32
6. Total wage bill, with bonuses, 1/	32.22	15.72	3.41	105.36	49.41	8.87
7. Payroll tax, 2/	9.21	3.91	0.85	33.5	16	2.3
8. Budget expenditure on health	5.43			27.45		
9. Budget expenditure on education and cu	7.96			24.34		
10. Budget expenditure on housing	6.6			28.67		
Social spending as:						
a part of distributed profit (line 5), %	14.29	12.98	15.36	26.26	24.64	-488.75
a part of total labor costs (lines 6+7), %	12.94	17.68	10.09	15.21	19.86	14.00
a part of wage bill (line 6), %	16.64	22.07	12.61	20.05	26.29	17.63
Total labor costs with social expend.						
as a part total costs (line 3), %	30.66	26.89	61.34	29.34	25.72	45.45
Social spending as a part of						
the total social budget spending, %						
- health (line 8)	18.23			10.16		
- education and culture (line 9)	7.29			7.31		
- housing (line 10)	29.70			22.60		

Source: Goskomstat, own estimates

Notes: 1/ as reported in Goskomstat in the form 10f

2/ estimate

3/ including VAT and Excises paid on inputs

Table 3. The structure of fixed capital assets at the disposal of Russian enterprises. 1/

	In bln rbl			as % of total		
	1991	1992	1993	1991	1992	1993
1. Stock of fixed capital assets, 2/	7780	28539	37409	100	100	100
o/w:						
- main (industrial) activities	7521	25418	33830	96.67	89.06	90.43
- non-productive activities	157	1051	1875	2.02	3.68	5.01
o/w: housing	56	333	1038	0.72	1.17	2.77
utilities	n.a.	n.a.	250	n.a.	n.a.	0.67
health	n.a.	n.a.	273	n.a.	n.a.	0.73
education	n.a.	n.a.	141	n.a.	n.a.	0.38
other	n.a.	n.a.	173	n.a.	n.a.	0.46
2. Flow of new assets: new construction		375	8541		100	100
o/w:						
- main (industrial) activities		343	7131		91.47	83.49
- non-productive activities		26	950		6.93	11.12
o/w: housing		16	707		4.27	8.28
3. Divestiture of social assets						
- all non-productive activities		10	253			
o/w: housing		5	126			

Source: Goskomstat, own estimates

Notes: 1/ without agriculture

2/ by the end of the year

The data show some increase in social spending as a share of the total labor costs. In 1993, total registered social spending by enterprises amounted to 17% of the total wage bill⁵ (in industry -- 22%) and to 13% of the total labor costs estimated as a sum of the wage bill and the payroll tax (in industry -- 18%). In 1994, these shares for the whole economy amounted to 20 and 15% correspondingly (Table 3). This aggregate data is consistent with the results of the large enterprise survey. As shown by the World Bank survey of 420 industrial firms held in the of summer 1994, average per capita social spending in this sample were equivalent to 18% of the wage bill. Social spending was positively and significantly correlated with the average cash wage. According to this survey, very few firms, only about 5% of the sample, did not provide any social services, while more than 60% provided five or more various types of such services (Commander and Lee, 1995).

The data suggest that 1994 social spending in industry as percentage of the cash wages returned to its traditional pre-reform level exceeding 20%:⁶ overall reduction in real enterprise social spending over the years of reforms did not exceed the decline in real cash wages. This makes a dramatic contrast to Poland, where the initial pre-reform level of social spending, of 6%, was only as third as high, and it has been showing some moderate decline since reforms started (Schaffer, 1995).

Under-reporting.

The presented data on the total enterprise social expenditure is likely to be significantly under-reported. This happens because of (i) insufficient enterprise coverage in Goskomstat form No. 10f used for preparing tables 2 and 3, and (ii) statistical biases in the data provided by enterprises.

(i) While the annual form 10f is supposed to cover the whole enterprise sector (as it follows from the employment data) in 1994, Goskomstat was able to collect this form only from enterprises amounting to total employment of about 85% of the overall labor force. One might assume that the most of largest enterprises, being the main providers of social services, are covered by this form, and therefore above mentioned under-reporting is not very large. Small firms, and newly-emerging private businesses in particular, are much likely to be under-presented in Goskomstat data. This part of the enterprise sector, however, is less involved in the delivery of social services.

(ii) A number of reasons, such as widespread barter transactions, the delivery of goods and services to employees at low prices, exclusion of depreciation and costs of renting corresponding premises from the total costs related to the provision of social services, etc., make the reported social spending volume substantially under-estimated. Enterprise managers had and retain incentives -- e.g. the excess wage tax - - to include some actual expenditures made in the social sphere under their general production costs by using deficiencies in the existing accounting classifications. Additionally, most social services are provided by enterprises on a non-profit basis. As a result, the opportunity costs of getting the same services through independent providers might be higher. Therefore, the actual burden of all types of social financing for enterprises is likely higher than that reported by Goskomstat but it probably does not exceed 4% of GDP.

⁵ Including bonuses from profit.

⁶ Estimated on the basis of Finance in Russian Federation, 1992. - M: Goskomstat, 1993, p.30; Russian Federation in 1992. Statistical Handbook. M: Goskomstat, 1993, p.p.121, 224.

Over-reporting.

There are also certain incentives for enterprises to over-report their social spending in order to increase benefits through available tax deductions. At the same time, it is very difficult to control the actual allocation of funds between production and social purposes within enterprises. Some types of costs are even not formally accounted for. In our survey, for example, a number of enterprises could not report their costs of heating supply for enterprise housing; they are not accounted for separately from costs of heat used for production purposes. Funds, which are reported to be spent on social activities, may actually be used quite easily for production needs. It seems, though, that the overall volume of such over-reporting is lower than the under-reporting discussed above.

2. FACTORS WHICH INFLUENCE SOCIAL ASSETS RESTRUCTURING

The principle groups of factors which influence the process of social assets restructuring are external economic environment and enterprise internal situation. Among the external factors macroeconomic environment, legal framework, financial framework and attitude of local authorities may be identified. The internal situation is primarily determined by the enterprise's financial situation and position of enterprise management.

Macroeconomic environment

Macroeconomic policy seriously affects the general process of enterprise adjustment and the restructuring of social assets in particular. Tightening enterprise budget constraints as a part of successful stabilization efforts substantially accelerates overall reductions in enterprise social spending. This includes spending cuts by those enterprises which are doing quite well and not experiencing severe financial problems. On the other hand, when the government's financial policy is soft and the progress with the enterprise reform is slow, even enterprises, which, at all accounts, are in poor financial shape, might be able to continue financing social services through accumulation of arrears to suppliers and to the budget, obtaining soft government credits or other forms of implicit government subsidies.

Ukraine might be considered as a good example of the latter situation. According to the IMF, Ukrainian enterprises spent about 4.6% of GDP in 1994 (i.e. measured as a share of GDP as much as they did before reforms have started (Cheasty, 1996)) on social activities. Some reservations aside, the opposite case might be found in Kyrgyzstan, where, as a result of the strong stabilization program, most enterprise non-housing social facilities were simply closed (ADB, 1995)⁷. It seems that enterprises in

⁷ Unfortunately, there is little evidence regarding the changes in enterprise social spending occurring in the transitional economies of Eastern Europe. Only the Polish experience is relatively well documented (Estrin et al., 1995). Given the radical nature of Polish stabilization, one might expect a quite substantial reduction in social spending by Polish firms. However, the paper by Estrin, Schaffer and Singh suggests that this did not happen. It is not clear if this should be considered as an argument against our hypothesis that successful stabilization plays a crucial role for accelerating decline in social expenditures of enterprises. Despite a very sound macroeconomic policy, the Polish economy has been characterized by a number of features, which unavoidably prevent enterprises from full and immediate discontinuation of social services delivery. The following factors are probably of major importance: (i) a very low initial, i.e. pre-reform, level of enterprise social spending; (ii) powerful labor unions

Russia, as well as in Kazakhstan (O'Keefe, 1995), implemented, on average, in 1993-94 a sort of an intermediary strategy when compared to either Ukraine or Kyrgyzstan. Some reduction in social spending has occurred and some social facilities shut, but the scale has been much smaller than initially expected. The reason for this can be found in quite internally contradictory economic policies conducted in both Russia and Kazakhstan.

General institutional changes can also seriously impact on the restructuring of enterprise social assets. The role of privatization and improvement of corporate governance mechanisms are very important in this regard. At the advanced enterprise reform stage and under transparent ownership rights, the continuation of social subsidies at the traditional level, even if possible financially, will become institutionally unacceptable.

One could draw some important conclusions from this cross country analysis. In particular, though cuts in enterprise spending in Russia are so far quite moderate, this could change dramatically as soon as (due to strengthening of government reform efforts) enterprise expectations regarding "prevailing rules of the game" are modified.

Legal framework

Legal arrangements concerning the status of enterprise social assets in Russia were first determined by the Federal Government during the process of enterprise corporatization and privatization (Annex 2). They varied across different types of social assets. A part of social assets (like health, educational, cultural and sport facilities) was allowed to be included under the charter capital of enterprises, with an obligation to keep the profile of these assets unchanged. Another group of assets, grouping together housing, attached utility networks (not on the territory of enterprises), as well as maintenance units of enterprises with all their so called "material base," are prohibited from being included in the charter capital and must be mandatorily divested to localities within a six month period after privatization, according to a time schedule approved by municipal administrations. Before such divestiture happens, such assets are to be held on the balance sheets of enterprises. Enterprises were not forced to have any social assets in their property (e.g. if working collectives did not want to do so and did not intend to include them in the privatization plan). In cases where some assets are located on enterprise territory but are used for municipal needs, they have to be transformed into a common property of the privatized entity and local authorities.

Differences in regional and local regulations concerning operation and funding of enterprise social assets play a major role in the determining of the actual legal framework in this field. There is much evidence that federal norms (which themselves are fragmentary and contradictory in many cases) are often either violated or ignored by local authorities who actually set up their own "rules of the game" (Bim, 1994, Urban Institute, 1995). For example, in some places, local authorities insist that almost all social assets could not be included into the charter capital of privatized enterprises, while elsewhere the process was mainly determined by the decisions of working collectives of privatizing enterprises.

(especially in privatized firms); (iii) effective government regulation of cash wage increases (popivek). Thus, the Polish developments, as seems, neither contradicts nor confirms our explanations of variation in enterprise social spending patterns observed across FSU countries.

In those areas where local authorities are weak and enterprises are strong, the federal rules are violated in a different way. For instance, in many cases heat supply systems (boilers), which are located on the territory of enterprises, were included into the charter capital and then local authorities have had neither access to the proper information on these boilers' activity (unit costs, technical characteristics) nor power over the supply of heat to municipal housing and other social facilities. As a result, heat tariffs for such heat enterprises are set at a too high level and the supply of heat is unstable (when enterprise needs more heat for production purposes it reduces supply to residents). The ban on reprofiling social assets, which have been included into the charter capitals of privatized enterprises, is also usually violated. In particular, many enterprise kindergartens were either reprofiled for commercial purposes or closed down after companies were privatized (Bim, 1994). In some cases, those assets, which were forbidden to be included into the charter capital (housing), were in practice privatized along with the fixed capital.

Arrangements concerning certain types of social assets are regulated by traditions. For example, recurrent costs for enterprise medical units were traditionally financed by municipalities, while enterprises had to compensate building maintenance and some overhead costs. Such a practice remains unchanged in many localities.

Thus, "the rules of the game" for social assets restructuring are only partially regulated by federal legislation (not very consistent in itself). In general, the actual developments are mainly determined by the main players at regional and local levels: regional authorities, municipal authorities and local enterprises, their balance of interests and relative bargaining power. Different fragments of federal regulation are used in different places, while the rest is ignored. As a result, the legal regime for social assets restructuring substantially differs both from federal rules and across municipalities. In the following sections of the paper, discussion is focused not on the formal regulations but on the real framework for social assets restructuring. Specifically, local differences seriously affect financial arrangements for both current operations and divestiture of enterprise social assets.

Financial framework

Two principle, yet opposing, views have been expressed regarding financial consequences of enterprises' social functions. The first, and more traditional (Shleifer and Boycko, 1994), suggests that the financial impact is quite negative and additional spending on social asset maintenance and operations leads to comparative disadvantages for enterprises which hold social assets versus those which are free of such obligations. The other position is that holding social assets does not highly affect enterprise financial positions (Teplukhin, Halligan and Willer, 1995). According to our analysis, the actual picture varies from city to city and enterprise to enterprise. Meaning that on the basis of the general analysis of both legal and financial environment, it is not possible to determine potential financial impact of maintaining social assets on the enterprises's financial performance because specific financial mechanisms of compensating social expenditures vary substantially between cities. Thus, the consequences for enterprises can vary greatly.

Principle additional sources of funding for the financing of enterprise social spending have been introduced by federal regulations and are currently uniform almost everywhere. It is the enterprises' right to deduct their social expenditures from both the profit tax (but not more than 50% of the tax amount due) and from 1.5% local turnover tax, which may be levied on all enterprises (and actually is introduced now almost everywhere) by local governments to specifically finance housing and social facilities. The

local implementation of these federal guidance varies a great deal across municipalities who use different options for the regulation of the profit tax and the turnover tax deductions. The following types of differences can be noted.

1. How costs are credited against corresponding taxes:

- a. According to actual reported expenditures of enterprises;
- b. According to special norms established by municipality for housing and other social assets maintenance and operations (for example, for housing they are measured in "rubles per square meter"). These norms vary substantially across regions, covering from as low as 40% of actual costs up to 100%.⁸

2. How tax credit mechanisms are established:

- a. Enterprises may credit their expenditures against appropriate taxes (according to any of the mechanisms mentioned above). If the amount of tax credits is not sufficient, local authorities (e.g. in Ryazan or Yaroslavl) may in some cases reimburse additional enterprise spending.
- b. Enterprises may credit the entire volume of their expenditures against appropriate taxes (according to any of the mechanisms mentioned above in para.1). If these tax credits are not enough to cover the full amount of spending, the city contributes nothing to support the enterprise social activity.
- c. No transparent rules regarding tax credit mechanism have been set and local authorities make individual decisions about tax deductions. For example, as Volgograd officials reported, there were no general rules for 1.5% turnover tax benefits in the city. In certain cases (for example, if an enterprise is loss-maker or works for city needs), a decision might be made to use preferential tax rates. Otherwise, an enterprise has to pay the full amount of the tax due, independent of actual social spending.

While both options "a" and "b" might be used in the framework of the existing federal legislation, option "c" openly contradicts the federal law, according to which social expenditures of enterprises should be deducted from the amount of 1.5% local turnover tax.

3. How deductions from two different taxes are combined.

In most cities, but not everywhere, the mechanism works in a way which allows enterprises to benefit twice from the same social spending. Turnover tax is paid before the profit tax, so turnover tax payments automatically reduce profit tax liabilities (which makes, on the average, the effective rate for enterprises

⁸ Besides, in some regions, local governments severely restrict the types of spending being eligible for tax credits. For instance in Moscow oblast, enterprise spending on heat and other utility services delivered to enterprise housing is not covered by these benefits. As a result, only about 20% of the actual housing costs of local enterprises are credited against the corresponding taxes (Kalinina, 1995).

equal to 2/3 of a statutory rate). While enterprises may decrease turnover tax payments by the amount of their social spending, they have a right to deduct full amount of the turnover tax paid (according to a statutory rate) in the process of calculating their profit tax obligations. From eleven cities considered for participating in the World Bank Enterprise Housing Divestiture project, eight confirmed that they have had this rule of double benefits.

There are other sources of financial support to enterprises in some cities. For example, municipalities sometimes declare social assets to be divested from enterprises, receive federal transfers to support these assets, and share these funds with enterprises, who actually retain the assets on their balance sheet. Such situations are possible, as we will argue below, because the term "divestiture" is still poorly determined by federal regulations.

It is worth noting that local authorities usually provide the above mentioned financial benefits not only to enterprises maintaining and operating social assets being kept on their balance sheets (therefore subject to divestiture), but also when the corresponding social assets had been included into the charter capital of privatized enterprises.

In some cases, federal and regional budget transfers are allocated directly to enterprises. In many rural settlements and one-enterprise towns, municipal governments still do not have adequate administrative capacity to manage corresponding assets. This is largely because in these places the largest firms were the historic providers of the bulk of social services. Due to this tradition, the enterprises, not municipalities, continue to receive subsidies from both federal and regional budgets and to run housing, schools, hospitals, kindergartens, etc. Governmental transfers for social purposes are the most significant in agriculture, coal, and defense industry sectors (See Annex 3).

Attitude of local authorities.

In general, city officials are interested in delaying social asset divestiture for as long as possible. This is especially true with regard to housing and utilities. According to the survey, municipalities in about 60% of cases have attempted to delay or stop this process (Table 6). Nine enterprises out of ten that have not yet started divestiture negotiations, foresee that these negotiations would be very difficult because of certain conditions imposed by city administrations. As a short-term solution, local authorities often try to introduce agreements between enterprises and city administrations on joint use and financing of social assets. In practice this means that enterprises retain the whole financial and management responsibility for maintenance and operation of social assets, while the city contributes from time to time some funds if they are available (from federal transfers or from 1.5% turnover tax).

In some cases, though, local authorities are very keen to receive the full control over social assets in the city and to start developing and managing the city social infrastructure as a single system. They therefore insist on social assets divestiture even if it means an additional financial burden for the city.

It would be very interesting to find out whether there are any objective factors, besides personal inclinations, which influence the position of local authorities. According to experience in the Enterprise Housing Divestiture Project, cities dominated by one or several large enterprises are at both extremes. In such cities almost all the housing and other social assets used to be controlled by enterprises and, as a result, local authorities were absolutely powerless and depended completely until recently for the delivery of many social services on investment decisions of enterprises. City administrations in these

cases either completely reject transfer of responsibility of managing social assets from enterprises or are much more radical than their colleagues from the other cities in their support to the divestiture. In larger and more diversified cities, the picture is also diverse. For example, in the middle of 1995 the share of divested enterprise housing in 12 cities, which were initially selected for EHDP, varied from almost zero up to 95%. In general, local authorities from middle-sized and even large cities are overloaded by their financial and managerial problems associated with existing municipal social facilities and are therefore quite reluctant to push for the additional burden posed by divestiture.

Position of enterprise managers.

On the whole, and all other factors being equal, the more difficult the enterprise financial situation, the larger are the pressures for restructuring social assets. This may be spelled out in various ways: stronger pressure on local governments to accept divested social assets, introduction of various service restrictions for non-employees, rising cost-recovery through increases in user fees and tariffs, etc. Coopers & Lybrand (1995) provides an example of the link between coal mine profitability and the level of cost recovery in housing financed by these mines. They show, in particular, that in early 1995, a profitable mine was capable of retaining an extremely low cost recovery in housing, at the level of 7.4%. Meanwhile, a neighboring mine, which had heavy losses, was forced to increase cost-recovery up 34.4%.

At the same time, there are a number of general characteristics of enterprise managerial attitudes towards social functions which are not explained by pure financial reasons and which have deeper psychological and cultural roots.

In general, most of the enterprise managers participating in the survey assess social functions as a significant burden. The attitude towards different kinds of social activities is the same. As one can see from Table 4, provision of social benefits associated with holding social assets are considered by enterprise managers as the most difficult ones. Social functions associated with provision of non-wage benefits including those in kind but which do not require holding substantial social assets (e.g. food shops with subsidized prices, transportation subsidies, direct distribution of commodities produced by enterprise itself or received through barter at subsidized prices) constitute a much less burden than the former. For example, Table 4 shows that in general it is much easier for enterprises to compensate their workers for resort recreation in cash than to hold recreation facilities themselves.

In addition, there are different attitudes towards two different groups of social assets. Kindergartens, housing and dormitories are considered as a major burden by a relatively large group of the respondents and the further fate of these assets is now the most painful issue for managers. It is much easier, though, for enterprises to continue holding such assets as sport facilities, cultural centers, hospitals and clinics.

On the basis of this information, it seems that enterprises should be eager to divest social assets, primarily those which constitute the main burden for them. However, our survey does not support this view. Only one out of 24 enterprises reported that it planned to stop providing all social services and one other had a clear strategy to make social activities self-financed. Six more presented a type of strategy where social assets restructuring may be considered 'rational' (meaning that these enterprises intended to downsize or to increase cost recovery of those types of social activities which are the most difficult for them to provide). The rest of the sample either had no strategy at all or their strategy could not be considered 'rational' according to the aforementioned criterion mentioned. Six enterprises were not going to change anything in their social activities, and three intended on providing new services.

Table 4. The most and the least problematic types of benefits as assessed by enterprise managers

<i>Type of benefit</i>	<i>Among 3 the most difficult to provide (number of responses)</i>	<i>Among 3 the most easy to provide (number of responses)</i>
Kindergartens	15	0
Housing	10	0
Dormitories	7	0
Recreation facilities	5	0
Canteen with subsidized prices	5	3
Compensation for resort recreation	2	3
Sport facilities	2	4
Cultural center	1	0
Healthcare facilities	1	5
Food shop with subsidized prices	0	2
Transportation subsidy	0	2
Commodities on subsidized prices	0	6

Source: Enterprise survey

Total number of responses: 24

Such an outcome contradicts not only the results of the other studies in this area, but also the answers to some other questions in our survey. For example, only two enterprises reported that they were not interested in housing divestiture. This means that the others who insisted on preserving all social functions expressed their intentions in an internally inconsistent way. It seems this phenomena has a psychological explanation and corresponds to traditional paternalistic attitude of Soviet enterprise managers towards working collectives. Even if in reality managers take some actions to divest social assets, they do not consider it appropriate to admit that they are going to leave their workers without some form of social support from the enterprise. This outcome is consistent with the results of the large World Bank enterprise survey where more than half of the managers of responding firms explained their continuation social benefits provision by non-economic factors (Commander and Lee, 1995). Certain objective reasons are definitely behind such social and ethical preferences of enterprise managers. The necessity to preserve good relations with local and regional authorities seems to play the key role here. Thus as managers have quite internally inconsistent feelings about divestiture, it is not surprising that their practical steps towards transferring social assets would not be very consistent and active, and they could be easily blocked by local authorities.

3. POSSIBLE WAYS OF SOCIAL ASSETS RESTRUCTURING

Options available. There are three possible solutions to the problem of enterprise social assets. Enterprise social assets can: (i) be kept by enterprises with or without changes in principles of their utilization, financing and ownership; (ii) be transferred to municipalities for further privatization of ownership and management; (iii) be handed over to municipalities to be kept under municipal ownership and management.

A significant portion of the overall social assets has been included in the founding capital of the former state enterprises and privatized along with the rest of the company (productive assets). Insiders consider (or at least used to)⁹ such privatization deals as beneficial for themselves because they saw profitable opportunities of either using or selling the associated real estate. Insiders voluntarily undertook the responsibility for maintaining these assets. There was no reason, therefore, for the government to consider plans of their divestiture or continue subsidization of their maintenance, including implicit subsidization through tax benefits. Among social assets which have been most frequently included in the founding capital of privatized firms are sport, recreation, and entertainment facilities. The costs of their operation might amount up to 25% of the current total costs of maintaining enterprise social assets. (See Annex 4).

According to the survey, enterprises consider various ways to use social assets at their disposal, including downsizing certain activities and making them self-financing. Among the methods to increase cost recovery, the most popular has been to attract new clients from non-employees and to increase user fees for them. The possibilities to increase fees from the enterprise employees and to reprofile and commercially use some social assets are also considered, though less frequently.

⁹ Sometimes when the owners change their mind, they manage to make a deal with the local administration and to sell these social assets to the city at symbolic prices; but in other cases they have to suffer from the results of their previous decisions regarding privatization, which have proven unprofitable.

In those cases where enterprises are keen to divest their facilities (e.g. in entertainment or other non-core social activities), the government should support this transfer, while not accepting responsibility for these assets. Instead, the government should develop and execute a privatization plan for corresponding assets based on the general principles of the overall Russian privatization program. This possibility is envisaged in Russian legislation (Annex 2).

There is, however, a large volume of social assets which either: (i) cannot be legally included into the charter capital of privatized enterprises; or, (ii) were not included for some reasons at the moment of privatization; and/or (iii) immediate privatization of which is not feasible. We will argue that the best option for this kind of social assets in a majority of cases would be divestiture to local authorities. While housing and utilities constitute the largest portion of such assets, the same is true for the part of educational and medical facilities.

Why divestiture, not privatization. There are a number of reasons why, for certain types of social assets, immediate wide-scale privatization is not feasible or efficient. This issue is discussed below using the example of housing and supporting utility networks, where most problems are concentrated, but the same factors afflict, though to a smaller extent, other types of social assets.

(i) Legal regulation. Legislation on privatization of apartments in Russia was formed in a way which is not very favorable for development of efficient private owners. It reflected the peculiarities of the social environment (historically strong tenants' rights), in which legislation had been developed. Tenants cannot be forced to privatize their apartments because privatization is considered as a voluntary action which they can do any time in the future. Meanwhile, apartments may not be privatized by outsiders. There are several consequences of legal arrangements in this area.

- Privatization of apartments changes nothing in the actual ownership and management of the whole building. For example, the building itself may still be considered as municipal property even if all individual apartments are privatized.

- The only currently available legal form for privatization of existing multi-apartment buildings in Russia is the formation of condominium associations. These, however, are very difficult to form on the basis of already occupied houses (Ryazan is the leading Russian city in condo formation with less than 30 condominiums formed by early 1996). Second, they are not the most stable and efficient form of private ownership for housing under existing conditions in Russia. Factors such as different level of incomes and demands of condo members, undeveloped housing market, lack of professional management, etc. will affect the condos' ability to enforce their ownership rights.

- Many households are not even interested in free housing privatization because their rights are well protected against eviction, even without a formal title for the apartment.

(ii) Subsidization. Housing in Russia is a heavily subsidized sector. On average at the end of 1995, residents covered between 20 and 30% of actual housing and utility costs. The rest was covered by subsidies either from local budgets (for municipal housing) or from enterprises (for enterprise housing). Residential utility tariffs are the same in municipal and enterprise buildings. The pace of elimination of subsidies is limited by both the general level of population incomes and by political constraints. For these reasons, many Eastern European countries, including Russia, Ukraine, and Lithuania, have found it difficult to eliminate housing subsidies simultaneously with overall price liberalization. As a result, these

are still the largest subsidies remaining in fiscal systems, and these countries have chosen a very cautious approach to their step-by-step elimination. Preservation of subsidies limits the possibility and desirability of truly housing privatization:

- Even if apartments and buildings from the enterprise housing stock are privatized, the responsibility for housing and similar subsidies is to be divested to municipal governments. In Russia and some other FSU states, when tenants privatize their apartments, it does not lead to any change in monthly household domicile expenditures. According to the existing regulations, any form of discrimination in maintenance/utility tariffs based on the ownership rights of the tenants is not allowed: all of them have to pay the same bills.¹⁰ This holds true for both privatized apartments and privatized buildings in a form of condominiums.

- The remaining subsidization will unavoidably shift incentives of actual and potential building owners. They would not feel too much responsibility for cost-effective management and maintenance of their property, but would have strong incentives to fight for extracting the full amount of budget subsidies. The situation is aggravated by the fact that tenants are billed according to special norms of consumption, not according to actual consumption. As such they do not have incentives for more efficient use of heat, water, gas. In this circumstances, while municipalities retaining major financial responsibility for housing, they should be more interested in rationalization of the housing sector than private owners.

(iii) Technical reasons. Provision of utility services has been organized in Russia in a way which is not very suitable for transition to private ownership of buildings. In most places, for example, heating is not supplied from small boilers serving one or few buildings; rather, both municipal and enterprise housing heat supply is organized through centralized heating systems. This necessitates the existence of one or several big heat suppliers and long networks connecting them with final users. Heat supply is interrelated across buildings and tenants do not have the technical possibility to regulate heat delivery in a decentralized manner. Some buildings lack even heat exchangers and water circulating within building heating systems is not separated from external pipes. (As a result, tenants have almost no way to influence delivery of heat or the quality of incoming water, which can badly influence pipes within their buildings.) Changes, which have to be introduced in this system to protect the rights of apartment owners, require certain investments and cannot happen overnight.

(iv) Monopolization of maintenance. Provision of maintenance services were originally organized to serve the needs of the centralized, state-owned and state-managed system. Though certain efforts to undertake reforms have been made recently in many localities, the level of artificial monopolization in this area is still quite high. Typically, the market of municipal housing stock maintenance is officially shared by several municipal maintenance companies and each building is assigned to one particular service provider. Enterprises usually have maintenance units in their structure, which provide corresponding services to the enterprise housing stock. Though it is less difficult to overcome monopolization in provision of maintenance services than in utility services, the absence of reliable alternative sources for these services may also be considered as a barrier to immediate efficient housing privatization.

¹⁰ And sometimes even lower. For example, to push apartment privatization, authorities of the city of Novochoerkassk made a decision to decrease by 3% all the rent and utility payments for the owners of privatized flats.

Why divestiture, and not "let the market decide"? There is one popular argument which contends that there is no need for government in transitional economies to interfere in the area of social benefits (including housing) provided by former state enterprises. The market itself would sort everything out anyway. Reasons for this conclusion are that: 1) firms in the established market economies also provide a number of non-cash benefits as a part of their overall compensation package; 2) social benefits are one of the ways in which firms compete on the labor market and thus enforced divestiture could affect mechanisms of market competition; 3) firms in transition have proven their ability to respond to changing economic signals and there is no reason to believe that they would deal with the problem of social benefits on their own less efficiently than they have with other adjustment problems (Schaffer, 1995).

While for a number of non-core benefits this type of logic seems to hold, the provisioning of core benefits, foremost in housing, by SOEs and former SOEs makes the situation in transitional economies and corresponding firms very much different from that in the countries with developed markets. The key difference is that those benefits, a real burden for the firms and a headache for governments in transition, are not a part of firms' compensation packages.¹¹ Enterprises must provide these services not only to their employees, but also to a substantial number of other residents in surrounding localities. Moreover, they have to provide these services at heavily subsidized prices, i.e.- they deliver public and subsidized housing services directly instead of the local governments. Due to political constraints, there is no hope that these subsidies will be terminated in short run. 'To let the market decide' in such environment is the equivalent to give firms permission to either withdraw unilaterally or to substantially reduce delivery of some basic public services. This option is considered as politically and socially unacceptable by most governments in transitional economies. The whole problem of divestiture is derived from the necessity to design a procedure that would substitute enterprises by municipalities in a way which preserves continuation of basic services and takes into account major fiscal and institutional consequences of such a substitution.

There are other important considerations which require governments' involvement in solving the problem of enterprise social benefits and, in particular, in accelerating divestiture.

(i) There is a serious difference in the provisioning of social benefits in money and in kind, specially where the latter includes holding social assets. Cash benefits are very flexible and can be adjusted in accordance with corporate financial situations. If these are reduced, for example, it does not effect the overall abilities to provide social services in the locality. This is not, however, true for social assets. It is virtually impossible to divest social assets in the short run if financial situation of enterprise is worsening. The manner in which enterprises deal with the problem in such situations is to simply stop operating and/or maintaining these social assets. Where enterprises are the main providers of social services (or at least play an important role therein) in many localities, such shutdowns could negatively affect general social conditions those locales.

This is especially true for housing where residents have no other alternative and enterprise reductions in maintenance funding lead to a general deterioration of living conditions. The other side of the coin is that badly performing enterprises with big social assets substantially increase their lobbying power and can force the government to provide financial assistance to prevent bankruptcy simply due just to the possibility of dangerous social consequences of corporate closure. Taking into account all negative social

¹¹ The level of social expenditures to cash wages per capita in Russia is 3-4 times higher than that in major Western European countries as reported by Schaffer (1995).

and political consequences of such situations (as well as financial instability of all the production sector in Russia) it is much preferable to undertake divestiture in normal, not emergency, conditions, preparing all the necessary financial arrangements, documentation and logistical preconditions.

(ii) Such social assets as accumulated housing stock can not be used in Russia as a tool of competition in the labor market. As mentioned above, enterprises have no right to either evict those employees who left the enterprises or to increase rent payments from them. They must also follow local policies regarding cost recovery increases. Any substantial revision of such arrangements is hardly politically acceptable. It would be considered as discriminatory of the housing rights of tenants in enterprise housing, which still forms at least 30% of the urban housing stock. Newly constructed housing may be included into the charter capital of enterprises and can be used in a more flexible way to support the enterprise labor policies.

(iii) In some specific sectors, the right of enterprises, in practice, to hold social assets results in substantial negative externalities. For example, railroads in Russia hold, fund, and operate a huge social infrastructure, which badly affects the level of railway tariffs. In turn, the level of train tariffs is now one of the main obstacles for growth in domestic interregional trade and improvement of enterprise competitiveness.

Thus, the problem of social assets, which are simultaneously (i) not included in the charter capital of enterprises, (ii) cannot be immediately privatized and/or (iii) are heavily subsidized, is a very painful one. Only two types of solutions, from our point of view, are possible to remedy this situation. Either enterprises continue to hold these social assets on their balance (with no right to make any strategic decisions about these assets and full or partial financial and managerial responsibility for their operation and maintenance) and enjoy some financial benefits established by transparent and fair rules; or municipalities take over these assets, which means full responsibility for their further fate, and finance them from general tax revenues. We will argue that from a long-term perspective the latter option is better for enterprises and economy as a whole. However, it must be seen as a transitional strategy that is accompanied by measures to push the ownership, financing, and management into the private sector.

4. CONSEQUENCES OF DIVESTITURE FOR ENTERPRISES

We have more information from the survey to analyze the process and consequences of enterprise housing divestiture. In this section, we will use the example of this critical sector of enterprise social assets to draw some additional conclusions. Most of the enterprises in the sample are interested in divestiture of their housing. Most, though, are still in the process of divestiture and have not completed it. Thus we may only use their estimates on potential consequences of this process. Enterprise managers, however, seem to take this process very seriously and almost all of them (20-21 from 24) were able to give their estimates regarding the possible effect housing divestiture might have on different aspects of enterprise performance (Table 5). In a number of cases, enterprise managers, as follows from their answers, have a different views on potential consequences of divestiture. In our view, these differences reflect the fact that managers' attitude towards social services in Russia has been a subject of a substantial adjustment process over last 3 years. This change in attitude is not completed yet and various groups of managers are at different levels of their adjustment.

Table 5. Potential consequences of enterprise housing divestiture as assessed by enterprise managers

<i>Issues</i>	<i>Total number of responses</i>	<i>Assessment of consequences (number of responses)</i>		
		<i>decrease</i>	<i>increase</i>	<i>no influence</i>
Financial burden	21	16	2	3
Managerial burden	21	19	0	2
Opportunities to hire workers	21	7	2	12
Prices	20	9	0	11

Source: Enterprise survey

Table 6. Sources of resistance to enterprise housing divestiture as assessed by enterprise managers

<i>Resistance from the side of:</i>	<i>YES (number of responses)</i>	<i>NO (number of responses)</i>
local administration	12	9
enterprise workers, specifically:	3	18
enterprise managers	0	-
trade union	1	-
workers of housing maintenance unit	2	-

Source: Enterprise survey

Total number of responses: 21

Table 7. Conditions included in housing divestiture agreements between enterprises and municipalities

<i>Conditions</i>	<i>Number of agreements</i>	<i>Were considered as the most difficult by enterprise managers in negotiations with local authorities (number of responses)</i>
Divestiture of housing in a good technical shape	9	4
Divestiture of heat and hot water supply systems	10	6
Divestiture of enterprise housing maintenance units	10	4
Sharing of maintenance costs	2	1
Sharing of capital repair costs	4	2
Sharing of utility costs	2	1
Continuation of housing maintenance and capital repair on the expense of enterprise	2	1
Continuation of housing maintenance and capital repair on the expense of municipality	5	-
Continuation of utility services provision on the expense of enterprise	3	-
Continuation of utility services provision on the expense of municipality	3	-
Total number of enterprises in the process of housing divestiture		11

Source: Enterprise survey

Financial impact. As a result of the aforementioned tax treatment and varying enterprise financial situations, the financial consequences of divestiture vary on case by case basis. Three enterprises reported that divestiture would make no impact on their financial situations¹², two even thought that financial pressure would be harder. Most enterprises, though, said that the financial result of housing divestiture would be positive. According to the general estimates, the enterprise sector as a whole is expected to gain only about 0.5 percent of GDP from the divestiture process in the short term. However, individual enterprises that provide a lot of housing will get substantial net benefits -- up to 70 percent of their current gross expenditures on housing (See Annex 4).

Administrative impact. Managers are more uniform in their answers about the managerial consequences of divestiture. The bulk of them agreed that managerial burden would decrease. This is only natural, taking into account that according to the survey more than 7% of enterprise labor was involved in the maintaining and operation of enterprise housing (either full time or accounting for more than half of their working time). Full employment in both housing and other social activities amounted to almost 18% of total labor. According to the Urban Institute (1995), about 20% of senior management time is typically spent on an enterprise housing related activities.

Impact on the attraction of employees. Managers do not think that housing divestiture would necessarily limit their opportunities to hire workers. More than a half of managers think that it would have no influence at all. Taking into account that many residents of enterprise housing are not enterprise employees¹³ and enterprises have no right to evict the residents or to increase the rent payment if the residents leave the enterprise, this should be no surprise. Increasing competition on the labor market and worker downsizing by many enterprises should be considered as important factors that dramatically change the overall labor market. In two cases, managers consider divestiture as a way to increase opportunities to hire workers; perhaps because this improves the financial performance of the enterprise. However, this situation varies, as 7 managers feel that divestiture would limit their abilities to hire workers; and in one case it was the reason for the enterprise not to initiate divestiture at all.

Workers themselves are also not very interested in holding enterprise housing (Table 6). Only three enterprises reported that their working collectives objected to the divestiture process. In only one of these cases it was the trade union who protested; in the other two resistance came from housing maintenance units of the enterprises. This is quite natural, as enterprises in many cases have reduced their expenditures on housing below minimally necessary levels and almost stop maintaining it, which leads to deterioration of the housing stock and decreasing comfort for residents. So, even those employees who live in the enterprise housing do not consider divestiture of the buildings to municipalities as a threat to their benefit package. They are quite sure that after divestiture rent payments will remain intact and housing services will not deteriorate further.

Impact on prices. About a half of respondents see no connection between enterprise housing divestiture and the level of prices for their products. The other half, however, considers divestiture as a possible source to decrease costs. They support the idea that in many cases housing divestiture might have a direct positive influence on enterprise competitiveness. It is interesting that enterprise managers

¹² Because of offsetting tax liabilities.

¹³ Employees or retired employees are living in 56% of apartments of enterprise housing in surveyed cities (of which the share of pensioners amounted to 14%).

have begun to understand the interrelation between the level of their social spending and their market competitiveness. This strict division in views among managers, as mentioned above, should be interpreted as a confirmation of the fact that during last 3 years a radical shift in managers' attitude towards delivery of social services had been underway but the change is not completed yet.

Impact on wages. This question was not asked directly in the survey, but data provided by enterprises and answers to other questions reveal some indicators in this area. It was expected that enterprise savings deriving from reduction in their social spending will facilitate cash wage adjustments, which, in its turn, will support reduction of budget subsidies for social sector and general public sector reforms. Following survey results, enterprise managers have not in practice enacted such a wage adjustment to compensate employees for reductions in real social spending. Only 1 out of 17 firms that had recently reduced delivery of social services said that they compensated employees through higher cash wage. The same findings have been revealed by the Urban Institute (1995), which reported that managers prefer to spend corresponding savings on purposes other than wage increases considered as being more important for enterprise surviving.

It seems that absence of a link between reductions in enterprise social expenditure and an increase in cash wages could be explained by the fact that the dynamics of the real cash wage has been determined so far by other factors. This is primarily by average prevailing wage levels in corresponding localities, which in turn largely follow the price level of basic consumer goods. Adjustments in the cost of living without reductions in non-cash benefits influence overall enterprise wage policies (Commander, Dhar and Yemtsov, 1995). Such implicit indexation of wages was rather effective in Russia in 1992-94 and caused a high level of real wage stability during the period of price liberalization and high and volatile inflation. This may suggest that, while managers do not currently use their savings from social spending cuts for wage adjustments, they may conduct different types of wage policies under different circumstances. Specially if cost recovery in housing is increased substantially and housing expenditures become a real factor in determining the cost of living. It is then likely that growth in employee housing expenditures, such as between 1992-94 with food expenditures, would be an effective determinant of managerial policies regarding cash wage adjustments.

5. CONSEQUENCES OF DIVESTITURE FOR MUNICIPALITIES AND ECONOMY AS A WHOLE

Divestiture and policy reforms. Various components of the Russian public sector require radical changes in their operational and managerial principals. Some presently public-funded services should be taken out from the public sector completely (housing). Others should expect either an increase in cost recovery (child care) or emerging of more flexible co-existence of public and private providers (health care, education). It might be difficult to achieve these changes without prior transferring social assets under full public control, i.e. without divestiture. First experience with housing reforms in Russia has demonstrated the practical advantages of having enterprise housing divested to municipalities. The latter currently have more managerial capacity and more incentives to push for housing privatization, increase in cost recovery, establishing housing allowances for poor households, etc. It may sound controversial, but the re-establishing of full public control over some sectors such as housing could be viewed as an important facilitator for success of subsequent privatization. Even when enterprises have to support a large housing stock, housing remains a sideline activity for them. Enterprises do not see themselves as the promoters of any housing reforms. For them, the preferable policy in this field is to be a passive, and

not necessarily accurate, follower of recommendations coming from local governments. The principle adjustment on the enterprise's part has been occurring through the simple cutting of funding for housing maintenance. As a result, enterprise housing in Russia is on average in worse physical shape than municipal one, has a slower rate of unit privatization, and has its tenants with less access to housing allowances¹⁴.

Gross potential fiscal impact of divestiture. An analysis of enterprise social spending structures demonstrates that the total incremental fiscal burden from full-scale divestiture will be much smaller than the current level of enterprise spending on social services. It could be argued that the potential gross fiscal impact is not more than 60% of the amount reported by the enterprises, i.e. close to 2% of GDP. This is due to the fact, as it was partially discussed above, that various types of social spending currently financed by enterprises are non-transferable (i.e. they are not subject to divestiture) either in financially or physically. These types of services include:

- (i) Those services financed not from enterprise revenues but from budget transfers. The corresponding assets might be transferred, but it will not impose extra budget costs upon if it accompanied by redistributing the transfers from enterprises to municipalities.
- (ii) Those services constituting an important part of the overall compensation package of employees as non-wage benefits. Under the existing economic climate, it is unlikely that managers of state-owned and formerly state-owned enterprises will insist either on divestiture of these services or their substantial reduction because the assets are not considered as a real burden by enterprise management. One might expect that real cuts will happen on their own only in the medium term as a result of substantial changes in both corporate governance regimes and taxation.
- (iii) Those social assets remaining in the enterprises' possession as a result of their privatization by enterprises.
- (iv) Those social assets, which should not remain in public possession in the market economy and must be privatized in case of divestiture.

Further, in some cases, the municipal costs of supporting divested assets might be smaller than those of enterprises. This is due to the fact that a part of social assets, owned by enterprises, is underutilized and overstaffed.¹⁵

Potential fiscal impact of divestiture for local and federal budgets. Since late 1993, cities have gained access to two new instruments to aid in the financing of social assets. One is the local tax for

¹⁴ From 9 cities which provided information on this issue in 5 cases privatization in municipal housing stock was higher than in enterprise one, in 2 cases it was equal and in 2 cases privatization was higher in enterprise housing stock.

¹⁵ For instance, in the Kyrgyz Republic, teachers' salaries in kindergartens managed by enterprises are 10-50% higher than those in municipal kindergartens. If the whole kindergarten system were rationalized to bring enterprise kindergartens to equivalent current municipal expenditure level with respect to food, salaries, and utility spending, the corresponding savings would amount to 20% of the current total costs of supporting kindergartens. (ADB & Associates, 1995)

support of social assets, a 1.5% tax levied on all enterprise sales; another is federal transfers for social asset divestiture. This means that the additional financial burden is shared between local and federal budgets. Three different situations of such cost-sharing should be considered:

- (i) Though the effective rate for turnover tax is much lower than statutory 1.5% (close to 1% according to our estimates), the total revenues from this tax are still quite substantial. For six cities involved in EHDP, the tax provided on average about 10% of the total budget revenues including transfers from federal and regional budgets. This new source could be potentially used to fund additional amount of housing divested from enterprises. In this case, the average net costs to local governments of the overall divestiture process would be on the order of only 3-4% percent of current total regional budget expenditures (0.6% of GDP). This gap would have to be covered by either federal transfers or households through an increase in cost recovery. The effect on individual cities (especially one-enterprise towns), however, could be quite different. In some cases a new financial burden for certain cities may be simply unaffordable.
- (ii) Since its introduction in late 1993, municipalities collected quite a lot of revenues from the turnover tax, but actual divestiture was very slow. These additional revenues were used to fund maintenance and operation of the existing municipal housing. As a result, local authorities put themselves in a much more difficult financial situation regarding further divestiture than could be if recent introduction of the turnover tax had been accompanied by the same rate of actual transferral of enterprise assets. According to our estimate, if the cities increase the effective tax rate of the turnover tax up to 1.5% and eliminate remaining profit tax exemptions, they will be able to raise about 0.7-0.8% of GDP as additional budget revenues. The full scale divestiture completion, however, will require about 2% of GDP in incremental expenditures. It is quite likely that municipalities will try to fund the remaining fiscal gap of about 1.2% of GDP or 6-7% of the overall regional budget spending by demanding support through the federal budget transfers.
- (iii) Some local officials argue that not only recurrent costs but also certain amount of capital repair of transferred assets should be funded. Enterprises did not maintain their housing stock as needed, so local officials assume that some additional investments in rehabilitation will be necessary just after divestiture to compensate consequences of recent poor maintenance. When such adjustment for capital repair is done (0.4% of GDP), the total annual fiscal gap for cities as a result of divestiture might be estimated as 10% of the existing regional budgets. Correspondingly, this amount, being an equivalent to 1.2% of GDP, should be considered as the upper limit for the amount of the federal transfers allocated across municipalities to support divestiture.

Federal transfers of this magnitude are justifiable only if all remaining housing and other assets have been accepted by municipalities. Recent developments in this field demonstrate that requests for the federal assistance filed by cities are growing much faster than the real rate of divestiture, and that the federal government does not have institutional capacity for proper evaluating real municipal needs in such transfers. Cities' requests for federal transfers in 1994 amounted to 20.7 trln rubl. or 3.3% of GDP (Urban Institute, 1995), while not more than a quarter of the overall enterprise housing stock was divested in 1992-94. After consideration of these municipal requests, the Russian Ministry of Finance allocated 12.1 trln (2.0% of GDP) for this purposes in 1994 budget, but later it disbursed only 4.5 trln during the year or 37% of the budgeted amount. Given the slow rate of divestiture, one can argue that this was a sufficient amount. To push divestiture, the federal government has had to develop a much smaller but much better targeted program of federal assistance, which would account for real variation

across municipalities in tax base, divestiture rate, and the stock of enterprise housing.

6. PACE AND BARRIERS FOR DIVESTITURE

Real rate of housing divestiture in Russia. Russian housing statistics are very much in flux, so it is not very clear how much housing was actually divested to municipalities. The report by the Urban Institute (1995) estimates that only 20-25% of the initial enterprise housing stock was divested in 1991-94. Evidence from various surveys has demonstrated that the actual estimate might be closer to the lower end of this interval. Our survey in December of 1994 showed that the share of enterprise housing in the surveyed cities was still above 40%.¹⁶ The large enterprise survey held in summer of 1994 revealed that by that time less than 5% of enterprises actually transferred any of their social assets (Commander and Lee, 1995). Only one from 24 enterprises participating in our small survey in December 1994 had completed divestiture of a portion of its housing stock by that time. The rest either still had been running negotiations with local authorities or had not even begun them yet. All figures prove that, in early 1995, at least 35% of the total urban housing stock was still financed by enterprises.¹⁷ In addition, divestiture in rural areas was even slower (See Annex 3). However, a part of the housing which is described as being financed by enterprises is, in fact, controlled and financed by various federal ministries (e.g. Defence, Interior), and this housing is not subject to divestiture.

Barriers for divestiture. While enterprises are generally interested in the process of housing divestiture, local authorities, as we discussed above, are reluctant to accept enterprise housing. The situation with enterprises in the process of divestiture negotiations is described in Table 7. Two main tools are used by local administrations to impede divestiture.

(i) All the housing is declared to be divested (which means little as formally housing is only on corporate balance sheets,¹⁸ not in their property), but enterprises are forced to keep responsibility for maintenance and operation of the same housing stock. As one can see from Table 7, it was envisaged in the divestiture agreements that enterprises are going to continue maintenance and capital repair on their own expense in two cases from 11 and continue utility services provision on their own expense in three cases from 11. However, as the definition of divestiture is very unclear and a variety of compromise solutions (as cost sharing agreements, for example) are legally possible. Local authorities use these instruments to delay the actual divestiture.

(ii) As preliminary conditions for actual divestiture, local authorities insist on a huge amount of capital repair to both the actual housing stock and utility networks be financed and carried out by enterprises. It is impossible to determine in general what amount of repair work is reasonable and what not, but this requirement can be easily used by local authorities to delay divestiture if they would like to. Such conditions, being very frequently included in divestiture agreements, lead to a number of conflicts. If the enterprise has no money and no ability to carry out repair work, the municipality sometimes demands to acquire some additional property to compensate these costs. As the mayor of one of the cities admitted, "if it (the enterprise) has no money, we can take cars, tractors, administrative

¹⁶ The enterprise housing share in the total urban housing stock initially amounted to about 45% in 1990.

¹⁷ This also includes some housing financed by federal ministries, such as Ministry of Defence.

¹⁸ In Russia, "na balance" means that the firm has use rights, along with the responsibilities for financing, operating and maintaining the asset, but technically does not own it.

buildings". Complaints for the same treatment were expressed by the respondents in the survey. The other conflicting issue is divestiture of enterprise housing maintenance units. Most of the enterprises have no problem with transferring employees from this unit to the municipality (divested maintenance units are usually included into existing municipal maintenance structures or reorganized into separate municipal enterprises), though employees themselves sometimes have different attitude, as mentioned above. The conflict is around the amount of assets (workshops, tools), which should be divested to municipalities along with housing. All these conflicts are quite sufficient to substantially delay the actual divestiture.

7. NECESSARY MEASURES TO ACCELERATE DIVESTITURE

Divestiture is a very complicated and painful process involving a good deal of financial, logistical, and administrative issues. Simple solutions are here not appropriate. The solving of some aspects of the problem may simplify control over the process and can create additional incentives to push divestiture further:

- (i) Definition of divestiture should be legally clarified. Local authorities may have a right to conclude co-financing agreements with enterprises and leave certain functions for maintenance and operation of social assets with them. Such arrangements should not be considered as divestiture though. Divestiture means transferring not only the use rights but also financial and managerial responsibilities to municipalities. Only in these cases should cities be eligible for federal transfers and other forms of support allocated for this purpose.
- (ii) An institutional framework to solve conflicts between local authorities and enterprises in the process of preparation and implementation of divestiture must be established. These problems should be probably solved on the regional level with the involvement, if necessary, of federal authorities but the existence of disagreements should not be used to delay divestiture forever.
- (iii) The methods of estimation of the net fiscal consequences of divestiture should be improved to make the overall picture more transparent for local authorities, who often do not know how much extra funds they will receive as a result of elimination of local turnover and profit tax benefits. This also will help to improve accuracy of regional requests for the federal transfers filed with the Ministry of Finance.

The divestiture of enterprise social assets imposes additional financial and managerial pressures on local authorities. According to the survey of municipalities, which examined this problem with regard to housing divestiture, even the existing level of budget subsidies for the housing sector is considered as a serious or even unaffordable fiscal burden. According to city officials, if the housing divestiture would be completed and the cost recovery level remains unchanged, the share of the budget allotted to housing subsidies would have to increase significantly, perhaps double or triple. As mentioned above, such estimates are on average substantially biased upwards. This is, in particular, due to the underestimation of additional tax revenues associated with divestiture. More active policy reforms can potentially ease excessive budget pressures derived from existing housing subsidies. Two types of activities should be given top priority:

- (i) Increase in cost recovery. By the time of the survey, cost recovery in the housing sector of surveyed cities was between 4 and 16% (despite the fact that the cities had the legal right to have cost recovery of 20%). By early 1996, with the legal right to have 60% cost recovery, the general level amounted to

between 20 and 30%, while some cities had achieved 40% by the end of 1995. While an increase in cost recovery will require more spending on housing allowances to protect vulnerable households, growth in housing tariffs on the whole would eventually transfer a part of the financial burden from municipalities to residents. Ultimately, full cost recovery is the only source of sustainable financing for the sector. Population income levels, however, put objective limits to the pace of this process.

(ii) Policy and institutional reforms. Current institutional arrangements in the Russian social sector are far from optimal and lead to huge losses in efficiency. Additional losses arise from poor technologies used in this sector. Financial analysis shows that it would be difficult to insure a substantial increase in cost recovery, and therefore reduction, in housing subsidies, without implementing a wide range of policy and institutional reforms, as well as investing in the existing housing stock to increase its efficiency (Freinkman, Tolstopyatenko, 1996). This means that divestiture would be unaffordable and, as a result, unsustainable in the long run without accelerating wide-scale housing and other public sector reforms. In many locations, these problems are quite well understood by authorities. Two types of activities are considered at the local level as a possible way to deal with them. First, local authorities try to decrease losses by encouraging saving of resources, first of all energy, which includes introduction of new energy- and water-saving technologies. Second, savings can be received as a result of policy and institutional reforms, specifically :

- demonopolization of the maintenance market, the attraction of private capital and privatization of municipal units in this area;
- better regulation of utilities as natural monopolies;
- ownership changes in the housing sector: creation of condominiums (as more radical changes are prevented by the concept of voluntary and potentially endless apartment privatization);
- management changes, including the introduction of private management.

Conclusions

This paper provides an analysis of available policy options with regard to the restructuring of enterprise social assets. It argues that these options are different depending on the type of provided social benefits; while some assets and corresponding services are expected to remain intact and continue to be a part of a traditional labor compensation package, other assets either have to be privatized or mandatorily transferred to municipal governments. Enterprise housing and, to a lesser extent child care facilities, should primarily be a subject of such divestiture. This would have a positive influence on both enterprise restructuring and public sector and housing reforms in Russia. Housing divestiture is considered as a transitional strategy that helps to accelerate the next step of transformations when the housing ownership, financing, and management will be transferred to a large extent to the private sector.

The paper also summarizes the current process of housing divestiture as conducted by Russian municipal governments. The existing "rules of the game" are highly non-transparent, and the whole procedure is largely determined by interests and relative influence of the players involved. Federal regulations are widely violated and only partially enforced. As a result, all major determinants of the speed of divestiture appeared to be under the control of local authorities; they have influenced to a great extent both legal and financial framework for this process, and have a number of opportunities for postponing or complete blocking divestiture.

Most of the enterprise managers, on the contrary, are interested in housing divestiture. They expect financial gains from this process (though cost reduction will be partly compensated by increase in tax payments) as well as radical decrease of administrative burden. Half of them admitted that housing divestiture would allow them to decrease prices for their products and correspondingly increase their competitiveness.

The paper provides quantitative estimates of the fiscal price of divestiture. The government will be required to spend up to 1.2-1.6% of GDP annually to support divested assets. To arrive to these estimate, we provide quantitative estimates of the overall social spending of Russian enterprises in 1992-94, as of 3-4% GDP a year, and evaluate the potential share of these costs, which will have to be covered by the consolidated budget after divestiture. It appears that the total enterprise social spending in Russia remains at its very high pre-reform level of 20% as a share of the gross wage costs. This makes the path of restructuring the Russian enterprise sector quite different from that of Eastern Europe.

While the overall fiscal price for divestiture is not too high, an efficient government support of divestiture will require an accurate evaluation of intra-regional differences with regard to the tax base and share of enterprise assets. Up to now, the Ministry of Finance does not have the capacity to make such an assessment. To make the process of divestiture sustainable in the medium and long-term, the Government must clarify corresponding regulations, encourage local administrations to increase cost recovery in housing, and to develop various alternative reforms for the housing sector which will foster a reduction in its excessive maintenance costs. If macro stabilization in Russia proceeds further, the government must be prepared to face much quicker reduction in enterprises' spending on maintaining their social assets.

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ANNEX 1. CHARACTERISTIC OF THE SAMPLE IN THE ENTERPRISE SURVEY

A special survey of 24 Russian manufacturing enterprises from ten different cities was conducted in December of 1994 by VTSIOM as a part of the preparation of the World Bank's Enterprise Housing Divestiture Project.

Location:

- single enterprise or single sector cities:
Novodvinsk - 1
Dzerzhinsk - 2
- cities dominated by several large enterprises:
Engels - 2
Novocherkassk - 3
Orenburg - 2
Komsomolsk-na-Amure - 3
- medium-sized cities with diversified economy:
Smolensk - 3
Kursk - 3
- large cities with diversified economy:
Volgograd - 2
Krasnoyarsk - 3.

Legal form:

- joint stock company with controlling interest in state hands - 3
- joint stock company with less than 50% of shares in state hands - 9
- totally private joint stock company - 11
- state enterprise - 1

Relation to privatization process:

- in the process of privatization - 5
- privatization process completed - 18
- privatization is forbidden - 1

Stage of enterprise housing divestiture:

- divestiture completed before 1990 - 1
- in the process of divestiture - 11
- interested in divestiture, but negotiations have not started yet - 10
- not interested in divestiture - 2

Financial and economic characteristics. While the enterprises in the sample varied substantially as to their sizes as well as magnitude of their housing burden, most were the large and extra-large firms (average employment for the sample was above 4300 in 1994), as from one to three largest corporatized firms were selected in each city. Most firms experienced substantial financial problems. During 1992-93 their average reduction in employment amounted to 25% of the labor force¹. In the middle of 1994, about 13% of their labor was permanently on unpaid leave. As a result of these problems, some 17 of 24 firms said they had reduced delivery of social services recently; while only 7 firms had not decreased the volume of provided social services.

Social and housing spending. At the same time, the firms were not able to reduce their spending on housing. Real spending on housing in 1994 remained at its 1993 level, while both cash wages and non-housing social spending declined in real terms. Tenants have paid as much as doubly-higher share of total housing costs in 1994 than in 1993. On average, each enterprise in the sample was responsible for maintaining more than 80 multi-apartment buildings with as many as 5000 apartments in them.

Total housing costs, denominated in per employee terms, amounted to 20% of the average cash wages², while the full housing and social costs made 35% of the average wage³. This provides a useful indicator of the scale of wage distortions which will be eliminated as a result of divestiture. Since total payroll costs for Russian industry are almost equal to the value of the gross profit, this data may also be considered as a measure of a potential gross financial benefits for enterprises participating in divestiture, without accounting for an offsetting tax effect.

It is interesting to note that 20 out of 24 enterprises have an accumulated stock of non-finished housing and they expressed the wish to complete construction of these sites if they could get sufficient funds. Enterprises reported that more than a half of their remaining employees were registered to receive a new apartment.

¹ All averages presented in this section are non-weighted.

² Expenditures on heat and hot water constituted about a half of the total housing costs.

³ Comparison of these results with the data from Table 2 proves that the social burden is rather unevenly distributed across enterprises. While for the industrial sector as a whole, average social costs amount to a quarter of both payroll and gross profit, for the largest providers this level is about 35%, which means that for many small and medium-size enterprises this amounts to only 10-15%.

ANNEX 2. MAJOR REGULATIONS GOVERNING ENTERPRISE HOUSING DIVESTITURE

RF Law On Fundamentals of the Tax System, December 27, 1991 (amended by Law On Introducing Changes and Amendments to Certain Russian Federation Tax Laws, December 22, 1992).

RF Law On General Principles of Local Self-Governance in the Russian Federation, August 28, 1995

RF Presidential Decree No. 721 On Organization Measures of Transformation of State-Owned Enterprises into Joint-Stock Companies, July 1, 1992.

RF Presidential Decree No. 8 On Use of Socio-Cultural and Communal-and-Personal Service Facilities of Privatized Enterprises, January 10, 1993.

RF Presidential Decree No. 2265 On Guaranties of Local Self-Governance in the Russian Federation, December 22, 1993.

RF Presidential Instruction No. 114-RP On Approval of the Status of By-Site Composition of Federal, State and Municipal Ownership and on Procedure of Ownership Rights Registration. March, 18, 1992.

RF Supreme Soviet Decree No. 3020-1. On Delimitation of State Property in the Russian Federation. December 29, 1991. (with editorial changes of May 23, 1992 and July 21, 1993).

RF Government Decree No. 86 On Procedure of Kolkhozes and Sovkhozes Reorganization, December 29, 1991.

RF Government Decree No. 708 On Privatization and Reorganization Procedure of Enterprises in the Agro-Industrial Complex, September 4, 1992.

RF Government Decree No. 1325 On Financing of Socio-Cultural and Communal-and-Personal Services Being Transferred into the Authority of Local Bodies of Executive Power during Privatization of Enterprises, December 23, 1993.

RF Government Decree No. 235 On the Order of Transferring of Socio-Cultural and Communal-and-Personal Services in the Federal Property into State Property of Subjects of Russian Federation and Municipal Property, March 7, 1995.

GKI Order No. 135-r On Streamlining of the Process of Differentiation of Ownership Rights to Socio-Cultural and Communal-and-Everyday Services of Privatized Enterprises, January 27, 1993.

GKI Letter No. 13/648 On Procedure of Transferring Enterprise Housing Stock, Housing Maintenance and Housing Repair Units Servicing This Stock into Municipal Ownership, January 24, 1995.

ANNEX 3. SOCIAL ASSETS IN COAL INDUSTRY AND AGRICULTURE

COAL

The coal sector has the largest single subsidy item remaining in the federal budget. The sector received about 1.2 % of GDP in subsidies in 1994 and, as estimated, about 0.6 % of GDP in 1995.⁴ Due to its privileged status under socialism, coal mines have accumulated a large number of social assets, which are currently a subject to the direct government financing together with covering operational losses of coal extraction. By our estimates, at least 125,000 employees, or 15 % of the total, of the state coal company *Rosugol*, are engaged in providing social services. Budget subsidies to support social assets amount to 17 % of the total budget funding, i.e. 0.19 % of GDP in 1994. This social spending per *Rosugol* employee accounts for about 28 % of their average wage bill. The Russian Government has developed a number of recommendations to re-channel the social subsidies from the mine associations to municipal governments in coal regions (Coopers & Lybrand, 1995). So far there has been little progress with their implementation so far.

AGRICULTURE

Agriculture is another sector of the Russian economy, in which firms are heavily involved in providing social services to both employees and local population and government finances their delivery through implicit and explicit subsidies. According to Goskomstat, agricultural farms spent 0.25 % of GDP on social services in 1993-94, which is about 8 % of entire enterprise social spending. At the same time, explicit government transfers to agriculture (not including tax exemptions), comprised 2.4 % of GDP in 1994⁵, and are about 10 times higher than direct social spending by farms. In fact, social services in agriculture are heavily subsidized by the government in an indirect way via subsidies to main farm products. This distorts incentives of all parties involved and make the financial environment within the sector non-transparent.

While potential fiscal impact of divestiture in rural areas is quite small⁶, there are a number of institutional and legal peculiarities of the status of social assets managed by agricultural farms versus those controlled by urban industrial enterprises, which complicate divestiture of these assets to local governments. As a result, divestiture in rural areas is progressing even slower than in the cities. This leads to two different kinds of problems. First, under the current financial crisis in agriculture, the quality of traditionally provided services has substantially deteriorated. In contrast to the cities, much of the rural population does not have access to alternative sources of supply of these services, especially in education and health. Second, the delivery of such important services via farms creates additional barriers for farm restructuring because of the disincentives for workers to leave the farms and because

⁴ As reported by the Ministry of Economy.

⁵ Figures are estimates on the basis of MoF and CBR data. This includes 1 % of directed subsidized credits from both CBR and the consolidated budget and 1.4 % of GDP of explicit budget (both federal and local) subsidies. Less than 10 % of these subsidies are explicitly targeted at supporting delivery of social services.

⁶ Rural social assets are relatively cheaper because housing makes a smaller share of these assets. In addition, rural housing has much lower access to utilities, and, therefore requires less subsidies.

closing loss-making farms is difficult when there is no alternative institutional framework for delivering social services.

Institutional features include:

- (i) A tax regime under which farms are totally exempt from paying some basic taxes such as profit tax and turnover tax and local authorities have no power to reduce these exemptions as social assets are divested. The local governments therefore lack a solid tax base to finance divested social services, and, compared with cities, rural local authorities have even less incentives to accept the asset transfer.
- (ii) The institutional weakness of local authorities in rural areas at the village level. Traditionally in Russia, local administrations in such places perform only very simple administrative functions, such as registration of what, and are not capable of managing delivery of social and housing services. Construction, capital repair, heat and other utility supply, etc. have been delegated to specialized divisions of large agricultural farms, and were not incorporated into the municipal government structure. Human capital is also inadequate for regulating utility enterprises in the case of the transfer of existing facilities into independent utility firms for servicing local social assets.
- (iii) Less scope for competition within the housing sector in rural areas, at least in the medium term. It is likely that large former state farms will still dominate at the local level and will retain control over maintenance services. The combination of non-competitive supply of services and weak governance capability of local authorities complicates asset, and especially housing, divestiture.

Legal features include:

- (i) Employees' rights. According to existing regulations, social assets managed by state or former state enterprises are subject to divestiture. However, about a half of all agricultural farms in Russia before 1992 had a legal status of kolkhozes (i.e. - they were collectively but not state owned). This means that legally the GOR cannot require the full divestiture of social assets from kolkhozes in the way that it can from former state enterprises, including former state owned farms. Instead, GOR's strategy is based on imposing restrictions for full privatization of the social assets and encouraging kolkhozes and former kolkhozes to divest them. In general, existing regulations regarding farms require social assets to be excluded from those farm assets that are subject of distribution on individual shares among farm members. These social assets might be, but are not required to be, transferred to municipal ownership or become a part of a non-distributable fund of the farm under restructuring. Housing might be transferred or sold to tenants.⁷
- (ii) Regional vs. federal ownership rights. The federal program of social asset divestiture is focused on assets maintained by federally owned enterprises, which are, as a rule, medium- and large-size industrial enterprises located in urban areas. With a few exceptions, enterprises in the agriculture sector are not, and have not been, federally owned assets. This means that the GOR has not committed to provide funds to compensate regional budgets for additional costs related to divestiture of rural social assets. As a result, the federal government is not in a position to impose strong pressure on local authorities to accelerate rural divestiture, and local administrations have strong fiscal disincentives to do so.

⁷ Government Resolutions No. 86 of 12/29/91 and No.708 of 9/4/92.

ANNEX 4. SOCIAL ASSETS OF VLADIMIR TRACTOR PLANT

As many large Russian enterprises, the Vladimir tractor plant used to provide a wide range of social services before 1992. Between 1992 and 1994, the enterprise faced a severe demand shock for its tractors, which brought about a substantial reduction in both employment and spending on maintenance of social assets. However, only a minor portion of these assets (some kindergartens and sport facilities) was formally divested to the city in this period. In 1994, the enterprise still had to cover losses related to the maintenance of these assets which cost the equivalent of more than 40% of gross profit. It should be mentioned that all social facilities listed below in Table 1, except housing stock, kindergartens, and educational facilities, have been included into the founding capital of the enterprise and privatized along with the productive assets. The management of the firm was not supposed to divest such assets as dormitories, sport, entertainment, recreational, and medical facilities, while their maintenance costs amounted to almost a quarter of the entire spending on social assets.

Table 2 presents the estimates of the potential financial gain for the plant, which might be associated with the full divestiture of social assets non-included in its founding capital. All other conditions with respect to financial flows and taxation rules are considered intact. The analysis shows that under the present regime, the plant enjoys substantial profit tax benefits, which offset 30% of the actual social spending. However, even when these exemptions are accounted for, the net financial gain for the plant from full divestiture of housing and remaining kindergartens still would be quite large, up to a half of the actual spending on maintenance of the whole stock of social assets or more than 20% of the gross profit.

Table 4.1. Spending on maintenance of social assets by Vladimir Tractor plant in 1994, mn rubl.

Housing	4082
o/w: Dormitories, 1/	850
Child care	1315
Sport facilities	108
Recreation facilities	160
entertainment facilities	118
Medical unit	87
Education	41
TOTAL Spending	5911
o/w: on assets subject to divestiture	4588
- "-", as % of the total	77.62
Spending credited against tax payments	5188
- "-", as % of the total spending	87.77
TOTAL Spending, as % gross profit	42.38
Memo:	
Gross Profit	13948
Total Sales	834900
1/ - estimate	

Table 4.2. Potential financial impact of divestiture.

	Before divestiture	After divestiture
	Actual	Estimate
Spending on maintenance of social assets	5911	1323
o/w: Spending credited against tax payments	5188	1000
Turnover tax payments	0	252
Profit tax exemptions (-)	1815.8	438.2
Net costs	4095.2	1136.8
Net costs as % of profit	29.36	8.15
Net gain from divestiture		2958.4
Net gain as % of the initial costs		50.05

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